How to prepare for EO—a practical guide for business owners

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This document, prepared by employee ownership specialists at Fieldfisher, offers a step-by-step guide to preparing for EO and summarises some of the practical actions business owners need to take.

For the purposes of this paper, we have assumed some knowledge of what employee ownership (EO) is and the forms it may take. If you have any questions or need further information, please contact one of our EO team.

1. Culture: Are you and your employees ready for EO?

Before making any decisive moves, business owners thinking about changing a company's business model should first ask themselves: Are you and your employees ready for EO?

This is not just a transaction backed up by some legal documents. If executed properly, EO will result in a fundamental shift in the way a business is run and how staff engage with management, customers and themselves.

Look at other EO organisations, especially those in your sector and any competing for your recruits. Do you like the ethos of those companies? What works and what doesn't work?

- Look closely at how your business is run. Sometimes, more time is needed before you can move to EO.

    - Do any senior individuals need to better understand what EO is about before supporting it (or leaving the business)?

      One of the key challenges of successfully transitioning to EO is to ensure that a good management structure is in place to take over the reins from any founders who are retiring from the business. EO is about legacy and building a sustainable platform for the future. Management needs to be ready for this.

    - Are there any business owners who are not ready to let go?

      There are no hard and fast rules here. Some business owners remain involved in the business for years to come, welcomed by the business. Others will move away from it immediately. Where management wants to make a fresh start, business owners may need time to get used to this and gain assurance that the business is in safe hands.

  Unless there are any significant time pressures, such as the age or health of key stakeholders (because it usually takes a few years to get paid in full for your shares), then you can afford to take the time needed to get the business ready culturally for EO.

- One of the many positive outcomes of examining how your business works will be the chance to identify different stakeholder groups. This will help when you and your advisers come to designing and implementing EO.

You may realise, for example, that the business depends on a group of highly motivated senior leaders and that it is too simplistic to think of 'all employees' as alike.

One question you might need to ask is: Do you need to think of ways to incentivise senior management?

You may also realise that existing shareholders fall into different categories and that retaining some participation by a founder or founding family will continue to benefit the company after its move to EO.

2. Finance: How are you going to fund an EO buy-out?

Get an indicative value of the company early on and decide whether you think the price is acceptable.

If the company is still growing, will you wait until it is more valuable before moving to EO?

Would you be happier with a trade sale, where you might have more than one potential buyer and will benefit from a bidding war?

Once you have an idea of value, some important points can be examined, such as:

- How will your employees fund the purchase of the shares? Will the finance have to come wholly or mainly from future company profits, so that payment of the purchase price is deferred over a n umber of years? How many years will that take? W hat will the business owner be comfortable with?

- Do you want to increase the initial payment by borrowing from a bank to reduce your risk? How will that funding be structured and secured?

Some payment structures can be quite elaborate – which companies may want for tax or other reasons – but where possible, it is advisable to keep things simple.

A practical tip in an EOT buy-out is to remember employees when budgeting cash flows during the period you are paying deferred consideration.

If the move is to majority EOT ownership, then include bonuses in your projections from the outset, not just deferred consideration payments.

This helps to show an immediate tangible benefit to employees and provide an 'instant win'.

3. Design: What EO model will work best for you?

- As a business owner, you will have the best idea of which EO model works for you.

  As you listen to the advantages and disadvantages of the different models, you will know which sounds most appropriate for your business.

  Is it important that employees buy shares to appreciate the benefits? Or is permanent EOT ownership the preferred way to 'lock up the equity' and allow staff to concentrate on being great architects, designers, manufacturers – or whatever the business may be?

- Your choice of adviser may influence the design of your EO model.

  For example, if you choose to be guided by a tax practitioner, the design may be geared towards securing tax exemptions, whereas an M&A practitioner may treat the transaction more like a third party trade sale.

  So assess what you want to achieve and choose your lead adviser accordingly.

- Moving to 100% permanent ownership by an EOT is perhaps the simplest option – as once the shares have been bought, this is a permanent, simple to maintain structure – but it may not work for every business.

  The main requirement under a 100% EOT structure is to hold meetings of the trustee's board of directors. The board will act as a benign controlling shareholding body, responsible for monitoring the implementation of the new ownership model within the underlying business and tracking its performance (without any obligation to interfere), to ensure that the model is working as anticipated in the best interests of the company and its staff.

  This is in contrast to operating an internal share market with direct share ownership, which requires administrative and financial support to facilitate share sale and purchases, such as share valuations, tax compliance, form filling and company administration.

  If direct employee share ownership is right for your business, however, there are lots of examples of EO companies that combine the two models to provide a bespoke arrangement suited to their business and employees .

4. Tax: Can you avoid taking tax advice?

The short answer is, ‘no’.

You cannot benefit from EO without meeting the requirements of some complex tax rules. Although it may be hard to believe, this is actually a positive thing. Many of these rules exist because the UK government wants to encourage EO and HMRC is supportive of the proper use of tax-advantaged share plans and EOTs. Because the tax reliefs available to EO businesses are generous, they must be policed

Make sure you stay within the spirit of HMRC’s rules on EOTs, as well as the letter of the law. As far as HMRC’s current rules on EOT transactions go, much of the detail and analysis relies on unpublished HMRC policy. You need to be clearly the right side of the line to be confident you can rely on this policy and your adviser needs to take you through what tax clearances are appropriate, given the level of tax risk you want to accept.

There are wide-ranging anti-avoidance provisions that HMRC could deploy if it feels the system is being abused. Although there is currently no evidence to suggest that EOTs are likely targets for an HMRC anti-avoidance crackdown, as EO becomes more popular, scrutiny is bound to increase.

- One way to simplify your EOT structure and its future administration is to have a UK incorporated tax resident trustee company. This gives you flexibility to design a trustee board that best supports EO in your business, without having to work with non-resident trustee directors.

  The alternative is to have an offshore trustee company. There may be good reasons to use offshore trustees, such as, for example, if you have an employee benefit trust (EBT) to warehouse shares to support an employee share plan, then there is a tax reason why, on balance, the EBT trustee needs to be an offshore company, with non-UK tax resident directors.

  But if an EOT is intended to hold shares permanently and has a controlling interest in the business then corporate governance may be more appropriately addressed by using a UK company as a trustee with a carefully constituted board.

5. Implementation: How do I make the model fit the business?

- It may be necessary to take some preliminary steps to enable a company to adapt to EO.

  For example, an EOT only works for companies, so you may need to transfer the trade of an LLP into a company, or bring associated companies together in a group.

  Moving to EO will involve a number of legal documents and everyone involved in the transaction needs to understand the implications of those documents and how the new structure will work.

  A documents list helps to show the range and scale of documents involved. This is not rocket science, but it is surprising how useful these things are.

  Working through them in a sequence also helps. For example, the sequence can be: tax clearance, then trustee company constitution and EOT trust deed, then the key buy-out documents and finally the ancillaries, board minutes etc.

- It is difficult to convert some legal documents into plain English.

  There are standard clauses and tax definitions that have to refer to language used in statutes and case law precedents.

  But it is possible to make some documents easier to digest – which in turn makes it easier and quicker for clients to understand what they are signing.

  It is often helpful for business owners to produce a 'handbook' summarising the whole EO structure and make this available to employees.

6. EO in practice: How do you make EO work?

- This is where business owners (now co-owners) take over from advisers.

  The first job will be to ensure that your employees embrace the EO model. Business leaders need to ensure that the EO structure delivers on its promises for employees.

  In an EOT structure there is usually a 'repayment period', during which much of the company's profits are paid out to the former owners. It can be difficult to manage employee expectations during this period, which is why some employee bonuses from year one are helpful.

  Aside from finances, there are wider engagement exercises which we recommend companies perform to make sure their staff fully understand the benefits of working for an EO company.

- Client communications – what you say to your customers – is also important.

  The key message will usually be, that 'it is business as usual, but we are planning for the future'.

- Crucially, you need to keep developing the meaning of EO for your particular business with all staff. Like any relationship, you need to keep working at it and cannot afford to become complacent.

  Highlight what it means to be employee owned, the benefits for the business, employees and often the community.

  With enthusiasm and commitment, EO will evolve and strengthen over time to act as an engine for growth and innovation in your business.

About Fieldfisher's employee ownership practice

Fieldfisher is a law firm with extensive expertise in advising, creating and sustaining employee ownership solutions for a wide range of businesses.

We are at the forefront of the drive to make employee ownership mainstream in the UK and elsewhere, offering real and exciting alternatives to the traditional business structures in the market. Our employee ownership specialists provide expert legal, tax and structuring advice for those wishing to establish and maintain employee owned businesses.

We pride ourselves on our practical, non-nonsense advice, backed by our deep understanding of the complex legal requirements and 10+ years of advising on employee ownership transactions.

Head of practice, Graeme Nuttall, as the government's independent adviser on employee ownership, set the agenda for employee ownership in the UK with "The Nuttall Review of Employee Ownership" in 2012.

We are committed to delivering the spirit of the Nuttall Review by advising flagship employee-owned organisations on maintaining their structures, and working with start-ups and growing companies so that they too can benefit from employee ownership.

About Fieldfisher

Fieldfisher is a European law firm with market leading practices in many of the world's most dynamic sectors. We are an exciting, forward-thinking organisation with a particular focus on real estate, energy & natural resources, technology, finance & financial services, life sciences and media.

Our network has more than 1,550 people working across 25 offices providing highly commercial advice based on an in depth understanding of our clients' needs.

We operate across our offices in Amsterdam, Barcelona, Beijing, Belfast, Birmingham, Bologna, Brussels, Dublin, Düsseldorf, Frankfurt, Guangzhou, Hamburg, London, Luxembourg, Madrid, Manchester, Milan, Munich, Paris, Rome, Shanghai, Turin, Venice and Silicon Valley.

Fieldfisher was named as a top 20 firm by the FT Innovative Lawyers Awards 2018.