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A practical guide to preparing for employee ownership in Australia

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Introduction

This document, prepared by employee ownership specialists at Fieldfisher and King & Wood Mallesons, offers a step-by-step guide to preparing for employee ownership in Australia. It considers culture, finance, design, tax, share offers, implementation and making employee ownership work in practice. This guide summarises some of the practical actions business owners need to take.

For the purposes of this paper, some knowledge is assumed of what employee ownership is, its benefits, why it may be preferable to other business succession solutions and the forms it may take. If you have any questions or need further information on these aspects of employee ownership, please contact a Fieldfisher or King & Wood Mallesons employee ownership team member.

This guide was originally published by Fieldfisher, a London headquartered European law firm, and has been adapted by King & Wood Mallesons for use by Australian companies preparing for employee ownership.

1 Culture: Are you and your employees ready for employee ownership?

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 employee ownership?

Employee ownership is not just a transaction backed up by some legal documents.

If properly executed, employee ownership will result in a fundamental shift in the way a business operates and how staff engage with management, customers and between themselves.

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

Look closely at how your business is run. Sometimes, more time is needed before you can move to employee ownership:

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

  One of the key challenges of successfully transitioning to employee ownership 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. Employee ownership 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 employee ownership.

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 employee ownership:

- 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 employee ownership.

- Remember that, generally, under company law all shareholders should have the same opportunity to sell their interests as the majority shareholders.

2 Finance: How are you going to fund an employee ownership 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 employee ownership?

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 the purchase of shares be funded? Will the finance have to come wholly or mainly from future company profits, so the payment of the purchase price is paid over a number of years? How many years will that take? With what will the business and business owner be comfortable?

- 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?

If there is too much of a financial burden on a business to commit to moving to 100% employee ownership, the business should assess if an initial target of 51% employee ownership will work, with the remaining shares to be purchased as a separate stage? 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 employee ownership trust buy-out is to remember employees when budgeting cash flows during the period you are paying for shares. If the move is to majority employee ownership trust ownership, then you should include bonuses in your projections from the outset, not just the payments for shares. This helps to show an immediate tangible benefit to employees and provides an 'instant win'.

3 Design: What employee ownership model will work best for you?

As a business owner, you will have the best idea of which employee ownership 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 employee 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?

Also, remember to check your employee ownership model is compliant with any regulatory or other requirements that are specific to your business.

At its simplest, there are two basic forms of employee ownership in Australia:

- Direct allocated share ownership where named employees hold particular shares.

- Unallocated share ownership where shares are held for employees collectively, without any individual allocations. This is the case for an employee ownership trust.

Historically, in Australia, there has been a preference for direct allocated employee ownership. However, in

Australia, in some cases direct allocated share ownership for unlisted companies can raise particular challenges.

More recently, there has been growing interest in Australia in the use of employee ownership trusts:

- If moving towards majority permanent ownership is the preferred option, then an employee ownership trust may be the simplest option for that majority shareholding – 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 an employee ownership trust 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 success of the 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.

  (If an employee ownership trust is intended to hold shares permanently and has a controlling interest in the company, then corporate governance may be more appropriately addressed by using a company as a trustee with a carefully constituted board, rather than individuals holding office as trustees.)

The above is in contrast to operating an allocated share structure with direct employee share ownership. Direct employee share ownership requires administrative and financial support to facilitate share sale and purchases, such as share valuations, tax compliance, form filling and company administration.

Direct employee share ownership may be combined with an employee ownership trust. There are lots of examples of employee owned companies that combine these two models to provide a bespoke arrangement suited to their business and employees.

Your choice of adviser may influence the design of your employee ownership model. It is important your primary adviser understands all aspects of employee ownership and is not focussed on only one element.

For example, a tax practitioner may gear the design towards securing tax exemptions and a mergers and acquisitions practitioner may treat the transaction more like a third party trade sale.

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

4 Tax: Do you need tax advice?

The short answer is, ‘yes’, you do need tax advice.

There are particular tax concessions available to the disposal of shares by certain small business owners that need to be considered. In addition, unfortunately, some of the rules dealing with employee ownership are complicated under the Australian tax regime.

Any model of employee ownership needs to meet the specific requirements of some complex tax rules. There are wide-ranging anti-avoidance provisions that may apply to employee ownership models. The requirements differ between direct share ownership and employee ownership trusts. If an employee ownership arrangement lacks substance and saving tax is your main aim, then it is likely you will have major problems satisfying these requirements.

The tax regulation of direct employee ownership is regulated by a specific regime. It is largely aimed towards taxing employees on any discount on the shares directly allocated to the employee if there is a dealing with the shares. Compliance with these rules is important to prevent unintended tax consequences for your company and your employees.

The considerations associated with the creation of an employee ownership trust are different. Unlike in the United Kingdom, in Australia there are currently no specific tax rules for employee ownership trusts.

The most important issues are associated with the mechanism adopted to provide funding for the acquisition of the shares by the trustee of the employee ownership trust. It is important there is strict compliance with certain rules as any disposal of shares is likely to be treated as a taxable event and have taxable implications.

The tax and other laws and practice concerning employee ownership arrangements in Australia are likely to evolve.

4 Share offers: Are there limits or restrictions on offering employees shares?

There are restrictions on offering shares to employees. These are very important in Australia, particularly for direct allocated employee ownership. They are less important for employee ownership trust arrangements. These restrictions require the issuing of various prescribed offering documents unless the offering can take advantage of a specific exclusion.

These restrictions may limit the scope of direct allocated employee ownership .

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 employee ownership.

- For example, an employee ownership trust is designed to work for a shareholding in a company, so you may need to transfer the business of a discretionary trust, unit trust or partnership into a company, or bring associated companies together in a corporate group.

- Moving to employee ownership 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 this is.

- Working through draft documents in a sequence also helps. For example, the sequence may be: the trustee company constitution and deed of an employee ownership trust, an employee ownership trust agreement, 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 are required to refer to the 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 everyone to understand what they are signing.

- It is often helpful to produce a 'handbook' summarising the whole employee ownership structure and make this available to employees.

6 Employee ownership in practice: How do you make employee ownership work?

Making employee ownership work is an ongoing process. This is where business owners (now employee owners) take over from advisers.

One task will be to ensure that employees, including new recruits, embrace the employee ownership model. Business leaders need to ensure that the employee ownership structure delivers on its promises for employees:

- With an employee ownership trust structure there is usually a 'payment period'. Over the payment period some of the company's profits are paid out to the former owners. It is important to manage employee expectations during this period. This 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 employee owned 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 employee ownership 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, employee ownership will evolve and strengthen over time to act as an engine for growth and innovation in your business.

Conclusions

Business owners who have heard about the benefits of employee ownership and its advantages as a business succession solution will want to know more about how to prepare for a move to employee ownership. This guide provides a step-by-step introduction to what's involved.

Typically, business owners will readily decide that employee ownership is a good fit with the culture of their business, and they will have an idea as to which model of employee ownership they prefer. By working through the financing, tax and other design considerations, they can confirm the right model for employee ownership for their business, and move on to implementing it and making employee ownership work in practice

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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.

It is 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 35+ years of advising on employee ownership transactions.

Partner, 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. Fieldfisher is committed to delivering the spirit of the Nuttall Review.

About Fieldfisher

Fieldfisher is a European law firm. It is an exciting, forward-thinking organisation with market leading practices in many of the world's most dynamic sectors, including 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.

About King & Wood Mallesons' employee ownership practice

King & Wood Mallesons leads the Australian market in providing advice to businesses on implementing employee ownership arrangements.

King & Wood Mallesons understand the importance and benefits of implementing employee ownership arrangements and assists its clients in preparing employee communications so that employee ownership arrangements and their taxation consequences are understood. The tax implications of employee ownership arrangements are constantly evolving, and King & Wood Mallesons ensures that it is at the forefront of all relevant market trends.

Its employee ownership practice is led by Andrew Clements, who is the Chair of Employee Ownership Australia, the central body promoting and implementing employee ownership in Australia.

King & Wood Mallesons is recognised by Chambers and Partners as Band 1 for Tax, highlighting our standing in the market as one of Australia's pre-eminent tax law practices.

About King & Wood Mallesons

King & Wood Mallesons is a firm born in Asia, underpinned by world class capability. With over 2,000 lawyers in 30 global locations across Asia, Europe, North America and the Middle East, we draw from our Western and Eastern perspectives to deliver incisive counsel.

The success of our global platform is underpinned by the strength of our local practices. As the clear market leader in China and Australia, and a top tier player in Hong Kong, Singapore and Japan, King & Wood Mallesons is the premier firm in the Asia Pacific. We continue to grow our European, Middle East and US practices and attract exceptional local talent in these markets.

King & Wood Mallesons also has a track record of advising a number of market 'firsts' across a variety of sectors and practices, including health & pharma, banking & finance, fintech, energy & resources, industrials & consumer and many others.

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This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal or other advice on any of the topics discussed.

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