Employee share plans:

More than a quarter of the 880-or-so listed industrial companies in Australia have some form of share plan. All plans are based on elements of six basic types:

1. Fully paid shares, financed by loans to employees (loan plans).
2. Fully paid shares, financed by company contributions (fully funded plans).
3. Fully paid shares, financed by employee contributions (savings plans).
4. Partly paid shares, financed by company and/or employee (partly paid plans).
5. Options to fully paid shares, financed by any means (option plans).
6. Replicator shares, fully funded by employer (replicator plans).

These basic types can be sub-divided according to whether they involve existing shares or newly created shares and whether the shares are held directly by the employee or indirectly through a trust. This is shown in Table 1.

Following this subdivision, there are eight types of loan plan (Type 1), four types of company-funded plan (Type 2), two types of employee-funded plan (Type 3) and Types 4, 5 and 6. Each type of plan has its own advantages and disadvantages.

As the company, its employees and the existing shareholders all have different concerns, each type of plan will affect them in different ways. Other interested parties include the vendor of shares, the stock exchange, the Australian Securities Commission and the unions.

Vendors may be disadvantaged by not having control of dividend distribution and access to inside information which can determine the sale price of shares. Stock-exchange listing requirements and the securities laws need to be met in introducing share plans. Unions may be interested in the impact of plans on their power base, industrial relations, economic democracy and enterprise bargaining.

At the national level, policy issues to be considered relate to tax revenue, national savings, productivity, competitiveness, foreign ownership and economic equality. All plans represent a compromise between differing and sometimes competing viewpoints.

How these various viewpoints are combined and constructed is more an art than a science. However, some general guiding principles can be considered in designing a plan for a given situation. But as a business changes in

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size, status or activity, the design of the share plan may need to be changed. Further, plans designed for one company may not be suitable for another.

**Option plans**

Option plans provide the most effective way to attract, keep and motivate key executives for start-up and developing companies. In these situations, venture capitalists and other investors are willing to accept the dilution of their ownership which is inherent in option plans. By giving employees options to take up shares, investors are in effect giving away some of their ownership. They do this because the potential gains in share value will more than make up for the sacrifice. They take the view that a little of something is more valuable than a lot of nothing.

In established corporations, too, option plans provide a cost-effective way for shareholders to attract, keep and motivate key executives.

In either situation, the employees are likely to be protected by management contracts and to have a large degree of control of the enterprise. The fact that options do not carry voting rights is therefore not a major concern for these employees.

**New shares**

New share issues to employees, funded by banks and other third parties, can be an attractive source of low-cost equity for companies requiring additional finance. The cost of this new equity can be minimised in a number of ways.

An important cost reduction for new equity can be obtained when the company can use pre-tax dollars to pay off the principal of employee loans. The tax advantage allows the loan to be repaid more rapidly to reduce both the loan risk and the cost of funds. Share plans can be designed to create "golden handcuffs" to retain key executives.

In some instances it may be possible to issue new shares privately to employees. This avoids the need to meet the requirements of a public offering of shares and avoids costs. If the directors can act to represent the interests of other shareholders rather than of management, then the cost of corporate capital can be reduced by issuing shares to employees at a higher price than would be acceptable in the market. This facility can be especially important for unlisted companies wanting to strengthen their balance sheets for creditors.

**Existing shares**

Mature corporations may be prepared to use their own funds to finance employee share plans. It is far easier to justify these plans to shareholders when company funds are being used to purchase shares already issued. This is because the purchase of existing shares supports the share price, avoids dilution of shareholders’ interests and promotes a more liquid market.

In contrast, issuing new shares to employees financed by corporate funds means that shareholders’ funds are being used to dilute their own interests.

**Replicator shares**

Some enterprises may not be able to issue shares or options, or may not wish to, because they are owned by the government, a family, or are a business unit of a larger organisation which may be a multinational corporation with its shares listed overseas. In these situations, phantom, artificial or "replicator" shares can be created.

Holders of replicator shares do not have rights to participate in the control and financial benefits of the enterprise on the same basis as other shareholders. Any rights they have are provided by the grace and favour of management and can be changed by management, as with any other discretionary bonus scheme. As replicator shares do not provide any corporate property rights, they cannot be traded or transferred to spouses and children.

Discretionary bonus schemes are often integrated into share plans. Management may provide a bonus on condition that the employee uses part of it to acquire shares or pay off a loan used to purchase them. Many "fully funded" share plans are designed so that the employer's contribution is determined by corporate performance. Sometimes the employer's contribution may be linked to that of the employee. Companies may contribute funds for the employee to purchase one or more shares for every share the employee pays for.

**Share trust**

The company may tie the transfer of shares to a promise that the employee will stay with the company for a nominated time. To allow the shares to be "warehoused", they can be issued to a trust. The trust may or may not allow the votes and dividends of the shares to be passed through to the employee and the employee may or may not have a say in how the trust is managed.

By using a limited liability company as trustee, the liability to pay off any loans used to acquire shares is not passed through to those employees who obtain a beneficial or contingent right to the shares. When loans are provided, any dividends received are normally used to first pay off the loan. The company may want to control the trust rather than provide for employee participation. However, it is normal practice to transfer shares to the employee as the loans are paid off. The employee then obtains the same rights as any other shareholder.

**Partly paid shares**

To avoid the need either to procure or provide a loan to allow employees to purchase shares, a company may issue shares only partly paid up to a nominated issue price. For example, a company may have shares of $1 par value which are trading on the stock exchange at, say, just over $5. When the company issues new shares to investors who wish to re-invest their dividends, it would nominate an issue
price of, say, $5 a share. The $4 in excess of the par value is described as a share premium and is allocated to a special share premium reserve in the company's balance sheet.

Employees may be allowed to purchase the $1 par-value shares issued at a price of $5 by paying only one cent. They would then have a personal liability to pay up not just the 99 cents to par value but the $4.99 to the nominated issue price. The directors have the power to request full payment. However, if the directors lose control of the company to a corporate raider, receiver-manager or liquidator, then it is these people who obtain the power to call up the unpaid amount. If the amount is not paid when called, the shareholders can be sued.

The dividend, voting and other rights of partly paid shares can be determined by the directors. It is unusual for the rights to be pro-rata to the paid-up value of the shares. However, some directors who have issued partly paid shares to themselves have been known to provide full rights, even to participate in bonus shares, when they have paid up only a nominal amount of one cent. The result is a transfer of wealth from shareholders to the directors.

Objectives of ESOPs

The design of employee share ownership plans (ESOPs) will depend on their objectives. There are seven basic common reasons for introducing ESOPs:

1. To provide additional short and long-term financial rewards for employees, at low cost to the company and linked to the rewards obtained by investors, in a way which which allows the additional benefits to continue after the employee retires. Benefits can continue for the spouse and children if the employee dies.
2. To provide employees with the same information, voting and other rights as the owners of the business, so as to improve communication, participation in corporate governance, job satisfaction and productivity.
3. To provide a low-cost source of finance which is controlled by individuals who have the most knowledge and commitment to the enterprise; that is, to create "relationship investors".
4. To create a means of buying out alien or foreign investors and allowing the local and national economy to finance its growth internally without foreign debt or equity.
5. To create a buyer for (a) business owner-managers seeking retirement or (b) passive investors seeking liquidity. In both cases, share plans can protect the long-term independence and so the future of the enterprise.
6. To preserve employment in firms which require new investment and create employment through financing new enterprises.
7. Philosophical commitment to a participatory work culture and/or a partnership between employees and other stakeholders — in a sense, enabling labour to employ capital rather than the reverse.

The technology of ESOPs can also be used to introduce ownership relationships with other operational stakeholders such as customers, suppliers and the community. This provides a basis for additional operational advantages and social support for productive economic activities.

Preferred plans from employee viewpoint

Plans which:

- do not require the employee to contribute any money or expose the employee to any financial liability. This would include all Type 2 plans and Type 1 plans which interpose a trustee with limited liability between the lender and the employee, such as Types 1c, 1d, 1e and 1f.

- provide employees with the same direct contractual rights as any other shareholder to participate in corporate control and to obtain dividends, etc. These plans would include Types 1a, 1b, 1e, 1f, 2a, 2b, 3a, 3b, 4a and 4c.

- provide the most acceptable compromise between avoiding personal liability and providing direct rights of participation in corporate control and financial returns. These plans would include Types 2a and 2b and could include Types 2c, 2d, 1c, 1d, 1g and 1h depending on the employees' rights under the terms of the trust deed and how well the trust deed protected the employees from the discretions of management.

Preferred plans from company viewpoint

Plans which:

- provide additional equity at the lowest cost. Type 3 plans meet this criterion, as could "Kelso" plans, or Types 1a and 1c. Type 4 plans could also meet this criterion where the company does not contribute to the cost of the shares.

- do not require the company either to invest its funds in loans to employees or to make additional payments to employees, such as plans 1b, 1d, 3a, 3b and 5.

- minimise the use of company money, either in loans to finance shares or in contributions to employees to allow them to fund share purchases, while providing the maximum incentive for employees to improve operations. All basic types should meet this criterion.

Preferred plans from shareholder viewpoint

Shareholder preferences could vary according to the situation of their company. For most companies the preferences would be:

- Plans which did not reduce the percentage ownership of existing investors and did not require company funds, such as Type 3b. Type 1b and 1d could also meet this criterion if the company did not make any additional provision to help the employees to pay off the loan.

- Plans which improve the value of the company's shares sufficiently to make up for any dilution in the percentage ownership of existing shareholders. Companies short of funds would prefer plan Types 1a, 1c and 4. Companies wanting to attract, keep and motivate key personnel, especially start-up enterprises, may prefer option plans (Type 5). Companies not short of funds could prefer Types 1f and 1h or Type 2.

<table>
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<th>Table 2: Which plans are preferred?</th>
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<td><strong>First preference</strong></td>
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<td><strong>Employee</strong></td>
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<td><strong>Company</strong></td>
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<td><strong>Investors</strong></td>
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<td><strong>Economy</strong></td>
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Preferred plans from the viewpoint of the economy

Plans which:
• improve the productivity and competitiveness of business. This can include all types.
• can be used to provide a new source of low-cost equity to finance business growth without the need for foreign debt or equity, such as Types 1a and 1b.
• can be used to buy out foreign investors, such as Types 1b, 1d, 2b, 2d and 3b.
• expand the number of individuals who have a direct stake in corporations in which they have an operational relationship, such as Types 1a, 1b, 1c, 1f, 2a, 2b, 3a, 3b, 4a, 4c or a contingent stake through options.

Ethical issues

The involvement of senior management and directors in share plans may introduce conflicts of interest between employees, directors and shareholders. While share plans can bring benefits to all parties, they can also be used by management and directors to further self-interest.

In recent years, this self-interest seems to have been the motivation behind much of the rapid spread of share plans. Investment activists such as the Australian Shareholders Association (ASA) have generated considerable media interest in the excesses of some plans.

To overcome the bad press and to provide guidelines on how the ethical issues might best be managed, as president of the Australian Employee Ownership Association (AEQA) I convened in 1993 a working group to consider these issues. The working group was made up of representatives of the Australian Institute of Company Directors (AICD), ASA and AEOA. The Australian Stock Exchange and the Australian Securities Commission also sent representatives and the Australian Investment Managers Group was kept informed.

The working group completed its objectives in 1994, when the ASA published its guidelines on acceptable practices for establishing share plans.

Appendix 1: Australian Shareholders Association guiding principles on share plans — 24 March 1994

Share plans should ensure that all parties share in the risks and rewards of the enterprise.

Share plans should be closely linked to profitability and to the long-term performance of a company, rather than solely to share price. This implies that share plans should concentrate primarily on profit sharing.

Share plans should provide a true incentive to increase profits (defined loosely as operating profit after tax but before extraordinary and abnormal items).

Share plans, while optional, should be open to everyone except non-executive directors.

Share plans for executive directors, executives and other employees should be fully substantiated to shareholders. All classes should participate in the same plan, according to the extent of their contribution as measured by their remuneration package. Bonus schemes and localised incentives are not precluded but should be specifically targeted.

Shareholders must be able to evaluate the projected outcome of share plans. This could be achieved by ensuring that share plans are fully described in plain English and their effects quantified by means of a number of worked examples using different assumptions.

Shareholders should welcome the trend towards increasing the incentive component of the executive compensation package by the issuing of shares through share plans. Ideally, a percentage of the executive’s total remuneration package should be earmarked for the purchase of the company’s shares.

Provided that shares are purchased on market, shareholders should be indifferent as to the percentage of share capital owned under share plans — to a limit of 25 per cent, say.

Comments on specific types of share plans

Fully-paid loan back plans

Acceptable provided that shares are issued at market price or at a small discount (5 per cent, say), and that immediate pay-back is demanded on termination of service. It is questionable whether such schemes provide sufficient incentive compared to plans of more modern design.

Options

Merit a cautious acceptance only. Options have been widely abused in the past, are difficult to quantify, and are usually granted only to directors, CEOs and very senior management. The recipients carry no risk, and can receive huge rewards through leverage while the shareholders carry all the downside.

Nonetheless, a limited use of options might be considered on a case-by-case basis. Typically, this might be:

• Options to form only the top slice of an executive’s remuneration package (after basic salary and company share plan components).
• Options to be medium-term (three to five years).
• Options to be performance-based with performance against competitors preferred.
• Options to be close-ended, not open-ended. A cap such as 50% of three times annual salary to be imposed.

Partly-paid shares

Generally unacceptable. Again, these have been widely abused. Because of leverage partly-paid shares are far too risky, introducing crushing liabilities when things go wrong. Instead of a spur to superior performance, they can act as a burdensome disincentive.

Share plan company or trust

The preferred choice. Newer share plans frequently use a share-plan company or trust to purchase shares on market on behalf of employees. The purchase of these shares is funded by the sponsoring company under a predetermined percentage of part of the extra profit earned (for example). Shares are allocated to employees and executives as part of their salary or bonus. Such arrangements are readily understandable, are quantifiable, and are readily negotiable. There are no loans and no partly paid shares involved. These plans are flexible and provide a powerful incentive by means of intermittent reinforcement — no shares are allocated if profits are down or fail to meet targets. Additional safeguards in the form of secondary or “senate” boards to adjudicate between the claims of interested parties are strongly recommended. [Refer to “Wanted: corporate whistle-blowers,” JASSA December 1992]