Ownership at Work

A PARTNERSHIP FUND FOR JOBS

How Government can help small business cope with the crisis

Nigel Mason

OWNERSHIP INSIGHTS

Sponsored by

Rm2

Foreword

The pandemic has presented UK business with an unprecedented threat. Without extraordinary and continuing measures thousands of companies may go to the wall, taking an incalculable number of jobs with them.

The Government, and specifically the Treasury, have been impressively innovative and radical in their financial support to limit the damage to the economy and individuals.

The positive reaction of business to the Coronavirus Business Interruption Loan Scheme and the Future Fund – just two of the new schemes – shows how necessary they have been. For understandable reasons, given the speed with which they had to be devised and their cost, almost all the Government's emergency schemes are short term.

The challenge now is to sow the seeds of a strong and lasting economic recovery. With small and medium sized firms [SMEs] accounting for nearly 17 million jobs and three fifths of employment, not to mention around half of UK income, this sector has to be at the centre of any recovery strategy, including the regions where SMEs dominate.

This paper presents an immediately actionable plan for one part of that strategy. The plan is innovative, but pragmatic. It builds on Government schemes that are already there; it requires no new institutions, no new legislation and it harnesses a movement already powering over £30 billion worth of turnover in the economy – namely employee ownership.

By combining companies' need for new investment with the strength of employee investment, the proposed new Partnership Fund addresses economic priorities to reduce inequality, build resilience and lift productivity – all proven features of UK employee owned business.

The Employee Ownership Association, the voice of that rapidly growing sector, welcomes the ingenious ideas set out in this paper. If harnessed by Government, a Partnership Fund offers the possibility of an ownership dividend to an SME sector in desperate need of a recovery path.

Deb Oxley OBE
Chief Executive, Employee Ownership Association

> **We're drawing down a £3 million CBIL loan from NatWest on Friday. It was quite shocking to hear from them how many applications they've had to reject – quite heart-breaking really. That leaves a huge gap which this scheme could plug.**

Contents

Ownership at Work

Ownership at Work

Ownership at Work's mission is to generate new thinking and ideas on employee ownership's contribution to the UK economy. An independent think tank, Ownership at Work publishes policy papers, guidance and research on the fastest growing business model in the UK economy. Holding charitable status, Ownership at Work is a politically impartial research partner of the Employee Ownership Association, the national body which speaks for the UK's £30 billion employee ownership sector.

Ownership at Work wishes to acknowledge the support of RM2 in the authorship and publication of this paper.

> **There's also the unseen and intangible benefit in terms of culture and additional drive and effort, which will be the catalyst to make that investment work that bit harder.**

Nigel Mason

Nigel Mason is a senior associate at RM2, having previously been owner and managing director. A mathematician by training, his early career was in banking. He became interested in employee ownership following a study tour of employee owned companies in the USA. Inspired by their success, Nigel started a number of businesses in the UK to advise and support new employee owned businesses. He advised the government on the introduction of the Share Incentive Plan and EMI share option scheme in 2000, and in 2014 advised the Coalition government on the introduction of the employee ownership trust, one of the fastest growing succession solutions for private companies in the UK.

RM2

RM2 is a 25 year old consulting business specialising in employee share schemes and employee ownership trusts for private companies. The multi-disciplinary team of lawyers, accountants, tax specialists and administrators helps clients design, install, finance and operate their employee ownership plans to maximum effect. As well as advising clients, RM2 staff do extensive pro bono work in the employee ownership sector, contributing their know-how through publications, blogs, policy papers, webinars and statistical analyses. RM2 became wholly owned by its employees in 2019.

INTRODUCTION

The speed, breadth and scale of the government's financial assistance for businesses in this pandemic – from the furlough scheme to the state-guaranteed business interruption loans – are extraordinary. Already, hundreds of thousands of jobs have been saved.

Yet UK unemployment claims still increased by 850,000 in April 2020 – a record number for a single month - to a total of 2.1 million[1] and forecasters are predicting the worst is still to come. And there are fears that the crisis will exacerbate existing regional inequalities, which this government has committed to reduce.

The furlough scheme in particular has provided support to 8.4 million employees, 30% of the national workforce. Presently, the government pays 80% of an employee's wage up to £2,500 per month with no requirement yet for the employer to make up the balance or to make any commitment to saving the job when furlough ends.

The scheme is very expensive, estimated to cost the government £80 billion[2], more than half the government's entire programme of pandemic spending. So the furlough scheme will be tapered down from 1 August, when employers will start to have to share the cost burden[3], and will end completely on 31 October, unless extended by the Chancellor. This is a time of maximum threat to jobs.

A second threat will emerge in March 2021. By then, businesses may still not have returned to their pre-pandemic levels of trading activity but will be faced with the triple whammy of interest starting to be payable on government-backed loans, deferred VAT payments falling due and the business rates holiday ending.

As part of the research for this paper the author tested the Partnership Fund concept with a focus group of leaders and owners of SME businesses. The quotes that appear throughout this paper are remarks made by participants in the focus group.

INITIAL RESPONSES

In response to the imminent ending of furlough, there have been calls for schemes that would allow willing employees to offer wage concessions in return for equity in their employer[4], in lieu of what would otherwise be a mandatory company contribution towards the employee's pay.

In SMEs, the wage concessions would more likely be negotiated on a case-by-case basis with individual employees than through across-the-board collective agreements, as few SMEs are unionised and some employees have greater capacity to accept lower incomes than others.

Of course, such arrangements are already possible and immediately actionable using schemes like Enterprise Management Incentive (EMI) share options, so why aren't they happening already?

There is the thorny issue of how to value the equity of a small private company in the middle of a pandemic. A bigger reason probably is that these concessions-for-equity ideas ignore the harsh reality that high unemployment and few new jobs mean that most employers can extract concessions unilaterally without having to give up scarce equity, as many employees are desperate to keep their jobs. Sadly, wages-for-equity on a large scale is wishful thinking without additional incentives for companies.

Whatever ideas are proposed, speed is of the essence and there is little time to invent a brand new scheme. We must work with the tools we have.

We also need to address incentives and think of safeguards:

- Why would an employer give up scarce equity when they can probably get concessions from employees already or make redundancies?
- Will wage concessions alone yield enough value to be worthwhile for businesses?
- What would protect desperate employees from exploitation or self-exploitation in these circumstances?
- How can the power of employee ownership, through greater engagement, involvement and participation, be unlocked and given the greatest chance to succeed?
- How can you value equity in a private company in the middle of a pandemic in a way that is fair and transparent and avoids gaming?

We need to look for existing government schemes that can be adapted very quickly if we are to mitigate the imminent risk of the tapering down of furlough, which is less than two months away.

[1] Source: ONS
[2] https://obr.uk/coronavirus-analysis/
[3] Employers will have to pay NICs and pension contributions of furloughed employees from 1 August plus 10% of furloughed employees' pay from 1 September, increasing to 20% from 1 October.
[4] It's time for an employee ownership revolution to aid recovery from Covid-19", The Times, 16 May 2020.

THE FUTURE FUND

From 20 May to 30 September 2020, private companies can apply for a co-investment from the government's new "Future Fund", administered by the British Business Bank, on the following terms:

1. Eligibility: unlisted private companies which have the majority of their employees or the majority of their sales in the UK and which have previously raised at least £250,000 in equity investment from third parties in the last five years.
2. The government will match pound for pound (from £125,000 up to £5 million) the amount raised from external investors. The government has set aside £250 million for this purpose and will increase that amount if there is demand.
3. To comply with the Financial Conduct Authority rulebook on investing in private companies, external investors must be "professional" investors.
4. Funding must not be used to (a) repay any shareholder loans; (b) pay any dividends; (c) pay any bonuses; or (d) pay any advisory fees.
5. The investment from both the Future Fund and the external investors must be in the form of convertible loans, bearing interest at 8% per annum but accrued rather than payable as cash interest. The terms of the investment agreement have been published[5] and are non-negotiable, ensuring rapid "take it or leave it" deployment. A solicitor must be involved but otherwise the process is entirely self-service and funds can be accessed within days.
6. Crucially, the vexed question of equity valuation is cleverly avoided by stipulating that the loans convert into equity at a 20% discount to whatever equity value is imputed by a future fund-raising or exit event.

Unlike the Coronavirus Business Interruption Loan Scheme (CBILS) and the Bounce Back loans, the Future Fund is aimed at investment-worthy companies of the kind that need equity investment rather than debt. As a result, the government hopes the scheme will eventually be self-financing. The terms are certainly not soft.

> **The one team approach is critical. You're taking employees into an unfamiliar world.**

PROPOSED PARTNERSHIP FUND

The following small adaptations to the Future Fund would turn it into a robust framework for implementing a wage-for-equity scheme on a large scale – what we have termed a Partnership Fund:

1. The eligibility criteria would be unchanged, except the requirement for the company having received prior equity investment should be dropped. Although this might imply a weakening of investment standards, it is worth noting that the furlough scheme is entirely unconditional and it is the winding down of this scheme that our Partnership Fund is designed to address.
2. The same matching principle will apply but instead of the matched funds coming from external investors they will come from employee concessions with the same de minimis of £125,000 per company. These concessions could be negotiated individually or collectively, though higher earning employees are more likely to be able to participate. The concessions can be easily valued and validated in the same way that the government is validating pre-pandemic wage levels through the HMRC-administered furlough scheme. For example, an employee previously earning an annual salary of £35,000 might agree to a 20% pay cut for 12 months, valued at £7,000 excluding employer on-costs.
3. In lieu of the external investor, the wage concessions would be overseen by the trustees of a newly created Employee Benefit Trust (EBT) which would include at least one independent professional person. The trustees would act as the legal counter-party in the co-investment agreement with the company and the Partnership Fund. Because trustees must act in the best interests of the employee beneficiaries, they must be satisfied that the concessions have been agreed fairly and without undue pressure. The EBT cannot be an all-employee Employee Ownership Trust because it is unlikely that all employees will be able to offer concessions on the same terms.
4. The same restrictions on the use of the funds in the Future Fund would apply in the Partnership Fund.
5. The same convertible loan financial instrument for investment in the company would apply. Because participating SMEs may not previously have raised external finance or be planning a conventional exit route, some tweaks may be necessary to the default conversion price[6] and the permitted realisation event[7]. The proceeds of the sale of equity would be distributed by the trustees to beneficiaries pro rata to the original value of employees' concessions[8].
6. Because this scheme involves employees accepting a higher degree of personal risk than the investment risk taken by professional investors, who manage well diversified portfolios, there is a case for the discount at which the EBT loan converts into equity being deeper than the 20% that applies to the Partnership Fund loan, and/or the accrued interest on the EBT loan being greater more than 8% per annum.

There are a few related changes that would be necessary to make the scheme work smoothly.

The wage concession agreement between the employee, the trustees and the employer could be in a similar form to a SIP[9] partnership share agreement, in which employees agree to a wage deduction to buy shares in the company. The anti-avoidance "disguised remuneration" rules, which levy an immediate charge to income tax on any benefits earmarked by an EBT trustee to a beneficiary, would need to be carefully navigated. And, presently, income tax is payable when a wage is due, whether or not it is actually paid, so the wage concession would need to be carefully structured.

[5] https://www.british-business-bank.co.uk/wp-content/uploads/2020/05/Convertible-Loan-Agreement-FINAL-VERSION-17.5.20.pdf
[6] The loans are guaranteed to convert into equity after three years or, as a strong incentive for the company to facilitate conversion, be repaid with an expensive redemption premium of 100%. If there has not been a fund-raising in the last three years from which to impute an equity value, the default value used in the Future Fund is that of the last fund-raising round. Because we are proposing to drop from the eligibility criteria the requirement for the company to have previously raised external investment, we will need a different default value for the Partnership Fund, such as NAV per share on the last accounting date before the drawdown date.
[7] A realisation event might need to include an engineered exit such as a repurchase of shares or a sale to an EOT.
[8] This would most likely be subject to income tax and NICs, so there is no tax advantage to this scheme.
[9] We did consider whether it might be possible to adapt the Share Incentive Plan for the Partnership Fund but we concluded that it would involve too big a departure from the current all-employee share-based SIP template. Nevertheless, it could be kept open as a reserve idea.

POSSIBLE OBJECTIONS AND RESPONSES

Perhaps the principal objection to the proposed Partnership Fund is the broadening of its scope to cover all private companies whether or not they have previously proven their investment worthiness. Could the government be throwing good money after bad, and could employees be making needless sacrifices to stay employed for a few months longer in a business that is destined to fail?

These are fair challenges. The de minimis threshold ensures the scheme can only be used by businesses of a certain scale, and there is strong evidence that businesses with broad-based employee ownership are resilient, flexible and resourceful[10]. Consider the alternatives: large scale and prolonged unemployment and thousands of businesses going to the wall.

Another objection is the risk of exploitation of vulnerable employees. The introduction of an independent group – the EBT trustees – should ensure a degree of scrutiny and impartiality to eliminate nefarious cases. If the worst comes to the worst and a business does fall into administration, the EBT trustees will at least have a seat at the table to ensure the fairest possible outcome for their beneficiaries.

Comparisons with the short-lived "shares for rights" introduced by Chancellor George Osborne in 2012, which offered tax-free shares to employees who waived certain employment rights, are inevitable but misplaced. Whereas that scheme was used mainly by highly paid employees in private equity backed companies as a tax avoidance scheme, the Partnership Fund involves no tax saving opportunity. Furthermore, to avoid this being an executive-only investment scheme, there could be a minimum participation threshold of 25% of non-director employees[11] to ensure a more inclusive outcome.

Finally, because higher paid employees are more likely to be able to afford to participate, there is a risk of creating division within companies between "contributors" and "non-contributors". However, this is not a phenomenon reported by the thousands of larger companies who operate contributory employee share schemes such as SIP and SAYE[12]. What seems to matter most is offering the opportunity of participation to all. And lower paid employees who might not be able to afford a pay cut could possibly be allowed to offer non-monetary concessions such as unpaid overtime or reduced holiday allowance, provided these can be verifiably valued.

> **We need to differentiate this clearly from the 'shares for rights' scheme, which was more likely to be used as an executive incentive than as an across-the-board scheme.**

[10] EOA (2018), The Ownership Dividend, The Economic Case for Employee Ownership, http://theownershipeffect.co.uk
[11] There should also be a requirement for all directors to participate, to show leadership.
[12] ProShare.org annual survey of SIP and SAYE

SUMMARY OF BENEFITS

The benefits of this arrangement are:

- New money is introduced into the company from the Partnership Fund in the form of subordinated convertible debt that ranks behind all secured debt, strengthening the company's balance sheet.
- Company cashflow is further improved by the wage concessions offered by employees.
- The use of an EBT ensures fair play and eases the administration; employee equity is pooled.
- Employees who can afford to accept a reduced income for a finite period save their jobs, the jobs of others and potentially the whole company in return for a potential equity return.
- The financial interests of the EBT trustees and the government are aligned because both want to see the value of the business increased. Rather than the British Business Bank holding hundreds of minority equity stakes in disparate SMEs, responsibility for those stakes is effectively delegated to those with the best knowledge and the strongest incentive to make the arrangements succeed: the EBT trustees.

CONCLUSION

In proposing the Partnership Fund as a way of mitigating the likely brutal effect on jobs of the imminent tapering down of the furlough scheme and the expiry of other subsidies, we have focused on a plan which we believe is targeted and actionable and which makes maximum use of the government's existing schemes so that it can be implemented quickly.

It includes incentives for companies, a degree of protection for employees and a potential return to government if businesses survive, both through the returns on the government's investment and the avoidance of enormous social welfare costs from unemployment.

Fundamentally, our Partnership Fund addresses the basic human need for greater security of employment and a fairer share of wealth.

> **The whole idea and the principle is great.**

> **The hassle factor – time and opportunity cost – is eye off the ball from running the business, so the more material the benefits can be, the better.**

Ownership at Work

Acknowledgements: The author would like thank RM2 for supporting this project, the Employee Ownership Association, who facilitated a focus group of SME business owners to test the idea, Ownership at Work, whose trustees reviewed the draft paper, and Tapestry Compliance Ltd for their technical review of the legal, trust and tax issues.

Sponsored by