Raising Equity from Employees

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When a company wishes to raise equity financing, more often than not, senior management looks to external sources such as private equity or venture capital. Given tight equity markets, an alternative source of equity financing could come from employees. The obvious advantages of this type of equity is that the employee understands and is engaged in the business so there is no need to have to “sell” the investment in the company to the employee investor. By taking on a shareholder role, the employee will generally be more motivated to support the growth of the company, less likely to leave the company and more likely to be concerned with the bottom line and managing expenses. The downside to this strategy is that the company will have to share financial information with the employee. This may be new for the company and can be uncomfortable. It is important to explain the financial statements to the employee investor to ensure that the employee understands his or her ability to positively impact the bottom line.

When employees acquire shares in the company, we recommend that the company organize its share structure so as to create separate series or classes of shares for the employees. For tax purposes, this enables the founders and the employees to maintain their paid-up capital in the company, which represents the amount of tax-free capital that can be returned to them.

Employees may not have excess cash to

invest in the business and may be looking for an equity share in the company as part of their compensation package. Companies can establish employee stock option plans that provide employees with the ability to acquire shares at discounted rates. In certain circumstances, the taxable benefit conferred on the employee by doing this can be deferred until such time as the employee eventually sells the shares. This is one alternative, but if the company needs cash for growth, it would be preferable to set up a plan where the employee actually invests fresh cash in the company. The simplest way to do this is to facilitate a structure where the employee can invest through his or her Registered Retirement Savings Plan (RRSP) or Tax Free Savings Account (TFSA). If the company and the employee qualify (this includes certain criteria as to the type of business carried on by the company and the requirement that the employee cannot own 10% or more of the shares of any class of the company or a related company), the employee can invest up to his or her contribution limit on an annual basis. ($22,000 is the maximum contribution for 2010. This applies to an employee earning $122,222 of employment income for 2009. The actual contribution limit will depend on previous year's income, pension adjustment, etc.) This amount may not seem worthwhile based on a single employee's equity investment, but if you are dealing with multiple employees, it can be significant. This allows the employee to access cash that he or she planned to invest in his or her RRSP and provides the employee with a tax effective way to invest in the company providing the employee with a tax deduction for the RRSP contribution amount. A TFSA can be used to invest in a company in a similar fashion, with a maximum limit of $5,000 for 2009 (indexed for inflation, thereafter), but the TFSA does not provide the employee with a tax deduction for the contribution. Both plans provide tax deferrals until funds are withdrawn from the plan.

From a management perspective, it is important to structure a plan that is appropriate for the individual company. Specific issues that need to be considered include:

- voting rights, dividends and frequency of shareholder meetings;
- disclosure of financial information: breadth, frequency;
- managing employee expectations;
- liquidity in event of termination, death, disability, sale event;
- non-compete, non-solicitation and non-disclosure restrictions.

The management philosophy of providing employee share ownership with access to financial statements is often referred to as “open book management” and has proven to be beneficial from a Return on Investment (ROI) perspective when correctly implemented in the right environment.

Barry MacTavish, a TDS securities lawyer, adds that securities legislation also will have to be considered when issuing shares or other securities to employees. Generally, trades by a company to those employees or those of its affiliates are exempt from the requirement to prepare and deliver a disclosure document, such as a prospectus, as long as the trade is voluntary on behalf of the employee and without condition on the part of the company. The exemption is also available for trades, among others, to the employee’s holding company, the employee’s spouse or a holding company of that spouse.

This article was co-written by Anita Wortzman, CEO of Acumen Corporate Development.

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