GRG Remuneration Insight 89

Employee Engagement & Equity Participation

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Introduction

In 1988 I had the privilege of working with Lend Lease Corporation Limited (LLC) to develop a ground-breaking employee equity participation plan. The plan was developed to enable LLC to continue to give effect to the philosophies of its founder Mr Dick Dusseldorp AO. Mr. Dusseldorp once said: "'Caring' and 'sharing' are concepts that attract minimal interest among many managers, who tend to see people as workers rather than workers as people…Yet I have found that such concepts, practiced in good faith, are powerful in their impact, particularly when productivity gain is seen not as a goal in itself but as a means to enhance life for all."

That few companies today have adopted Mr. Dusseldorp's philosophies may represent one of the reasons for the lack of success evident in many of the so called leading Australian companies. This GRG Remuneration Insight reflects on the work done so many years ago and considers how it may be applied in today's regulatory environment to improve employee engagement, participation and company performance.

Ownership, Participation, Engagement & Results

The plan that was put in place at LLC involved the company facilitating for employees to become part owners of the company, so that they could participate in its success thereby encouraging improved employee engagement leading to improved results. There is a growing body of evidence, beyond LLC, that broad employee equity ownerships does improve the engagement, commitment and performance of employees, and that this contributes to improved company performance.

There were some unique features of the LLC Plan and some of them are unlikely to be replicated today. These unique features were:

- A share of profits being allocated to an annual pool for distribution among all employees,
- The profit share pool was distributed among employees on an egalitarian basis i.e. pool ÷ number of employees = same dollar value share for all employees,
- Each employee's share of the pool was converted into a shareholding in LLC,
- The shareholding was fully vested at grant i.e. it could not be taken away from the employee, and
- The shareholding had to be retained for some years before it could be sold (disposal restrictions, in today's language).

Thus, the plan resulted in long term ownership of the company by employees who participated in success via dividends and share price growth and thereby were encouraged to collectively optimise their contribution to the company's success.

Taxation Impediment to LLC Style Plan Has Been Removed

The employee share scheme (ESS) taxing provisions that prevailed at the time the LLC Plan was implemented aligned the taxing point for the value of the shares with the point when the shares could be sold by the employees. This was a logical outcome and while it delayed the timing of the tax payment to the government, it did not result in loss of revenue for the government as the value that was eventually taxed was generally significantly higher (more tax paid) than the amount of the profit share converted into an allocation of shares at the outset.

In 2009 the Government changed the ESS taxing provisions such that, other than for some relatively minor concessions, the taxing point could only be deferred if there was a real risk of forfeiture of the equity (shares, rights and options). Such risk was inconsistent with the principles of the original LLC Plan and discouraged the use of general employee equity participation plans except for the minimal $1,000 tax exempt plans, because it created a tax burden or risk for participants. For most employees this tax treatment made such plans ineffective and broad employee ownership virtually disappeared, other than at the minimal level.

In 2015 the ESS taxing provision were changed to largely reinstate the provisions that prevailed when the LLC Plan was introduced. In some respects the new ESS taxing provisions are even more supportive of general employee equity participation plans than they were prior to 2009.

Features of General Employee Equity Participation Plans

The following raises and comments on possible design features of a general employee equity participation plan (GEEP).

Participation

The graph on the following page depicts the current situation of many companies which is that they have:

- a $1,000 tax exempt plan for all employees - the green, flat line in the diagram, and
- a long term incentive plan for the CEO, Direct Reports and a limited number of key contributors and high potential executives (typically less than 20 participants) – the blue lines in the diagram.

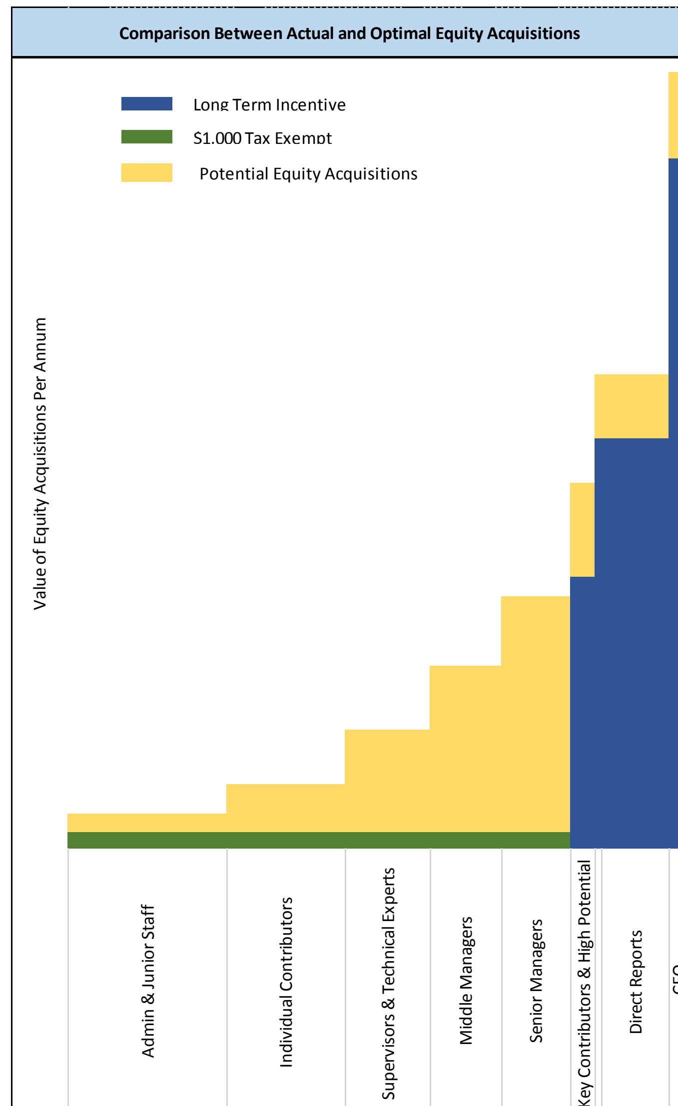
The graph indicates the amount of equity that could reasonably be provided to the majority of other employees at various levels, in addition to current practice (the $1,000 plans and LTI or deferred STI). This is represented by the yellow area of the diagram. This is referred to as "Potential Equity Acquisitions" in the following analysis, and reveals:

- an enormous gap between the equity offered to the LTI plan participants and the amount of equity that could reasonably be offered to the next four levels below them, being:
    - senior managers,
    - middle managers,
    - supervisors & technical experts, and
    - individual contributors, and

- a modest gap for the remainder of employees.

The $1,000 tax exempt plan does little towards providing an employee with a reasonable equity stake in the company, or aligning their interests with other stakeholders.

Given the links between ownership, participation, engagement and results it follows that participation in equity plans should be open to all levels of full-time and permanent part-time employees and even to individuals who have similar relationships with the company but as a contractor or casual employee, for example.



NB: The above graph is illustrative and not drawn to scale.

Funding the Equity Acquisitions

There are three funding alternatives that may be considered being:

1. employee funding via salary sacrifice which may be from fixed pay or short term incentive awards – these involve no additional funding costs to the company but can be attractive to employees because of the taxation advantages inherent in tax deferral,
2. company funding which would be from additional remuneration such as awards related to company performance via a profit share, comparable to the LLC Plan, and

3. split funding between the employee and the company which may take the form of salary sacrifice which is matched by company funding between say 20% and 50% of the employees funding cost up to a specified limit.

Of these alternatives, 1 and 3 are most likely to appeal to many companies particularly during periods when there is a strong focus on cost control. Alternative 3 has the advantage of companies being able to exert influence over employees to retain equity over the longer term without imposing restrictions that may be seen as unacceptable in relation to salary sacrificed amounts. Instead, the offer should be structured to ensure that the employee may realise more benefits from holding equity longer.

Rights Not Shares

The LLC Plan used shares in the company acquired at the time of the award, as the instrument of the plan. However, since that time the ESS taxation provisions have changed and a draft ruling has been released by the Australian Taxation Office (ATO) indicating that new interpretations of the application of taxation laws are likely to apply to employee remuneration trusts which hold shares for extended periods. This draft ruling was released many months ago and at the time of writing this GRG Remuneration Insight had not been finalised.

In these circumstances the better approach is to use rights as the instrument and to provide dividend equivalent awards to ensure that employees are not disadvantaged through the use of rights instead of shares. Of course, when rights are used they generally result in the issue of shares on exercise and such shares would not need to be held in an employee share trust for any length of time.

Plan Limits

If rights are used then there are no taxation limits that apply to the number or value of rights than may be provided either to an individual or in total. If a product disclosure statement (PDS) is not used in relation to offers under the plan then ASIC Class Order 14/1000 will generally need to be relied upon by ASX listed companies for relief from the PDS and other provisions of the Corporations Act. If Class Order 14/1000 is relied upon then a limit of 5% of issued shares will apply over a rolling 3 year period.

Shareholder Approval

General employee equity participation plans generally need shareholder approval and grants to directors will also need shareholder approval if new issues of shares may be involved.

Conclusion

Companies that are interested in implementing employee ownership plans to facilitate participation and build employee engagement with a view to improving company performance for the benefit of shareholders are now able to do, for the first time in many years. It takes time to consider how the features of such plans could be configured for a particular company context, to finalise a plan design, develop the required documentation and obtain the necessary shareholder approvals. Thus, if there is genuine interest to introduce an employee equity participation plan then companies need to start the process as early as possible.

GRG is currently assisting a number of large ASX listed companies in the design, implementation and administration of such innovative plans. While they may be early adopters, it is anticipated that these practices will spread quickly.