BVCA response to BIS consultation on implementing employee-owner status

This response is submitted on behalf of the British Private Equity and Venture Capital Association ("BVCA").

The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

Overall, we agree with the principles behind the proposals that the Government has put forward. As we make our way out of recession, it is vital that private sector growth is stimulated, and one key way in which this will happen is in a strong and vibrant SME community. Large businesses are important, but we believe the growth potential, particularly in employment, lies with start-ups and small companies. As such, any moves towards making it easier for small and growing businesses to hire new staff and grow are to be welcomed, as are any moves which give employees a stake in the businesses they work in – allowing them both to share in the risks of the business, but crucially giving them a stake in the rewards of the business, and helping to ensure that the entire business is focused on achieving growth.

We believe that the scheme outlined by the Government has much to recommend it and, if properly implemented, could make a real difference in terms of encouraging hiring of new staff and greater employee ownership within small and growing businesses – particularly those at the start up level, where the risks associated with taking on new staff are most keenly felt. It is important though to communicate this policy shift carefully. It will not be right for every business, particularly those that are well established, so the expectation should not be one of universal take-up. Many employers will be reluctant to impose the scheme on current staff. It is also imperative that employees understand that the scheme is entirely voluntary and they cannot be forced to give up any employment rights. This should not take away from the fact that for new and small companies with committed staff, this could be an excellent way of structuring their employment plans.

We must now make sure that the scheme is able to achieve its full potential in encouraging small and start-up businesses to take on new members of staff by implementing it properly.

This means allowing for as much flexibility as possible in implementing the scheme, enabling companies to work with their new employee-owners to ensure the best result. The proposals focus on a narrow section of employment regulations – unfair dismissal and maternity leave – and do not affect the majority of other employment regulations which are of concern to businesses, including but not limited to:

- Discrimination
- Payment of the National Minimum Wage (which can prove a problem for start-ups which are not generating revenue)
- Statutory holiday pay
- The right to take paid maternity/adoption and parental leave

Each of these aspects of employment law could be seen to a greater or lesser extent a barrier to small and start-up companies taking on staff, and a set of policy proposals which tackle only one aspect of them will be proportionately limited in its impact. We do understand though that some of these fall under jurisdiction of European Law, and therefore the Government's room for manoeuvre is more limited.

In general, we believe that the starting point of any legislative change in this area should be that it imposes as few burdens as possible in terms both of the time needed to comply with any requirements, but also in terms of the costs of bringing in outside advice – for instance on valuation of shares. We do not want company directors to become de facto financial advisors but nor should we expect them to pay out significant sums to bring in external advice. Any such costs will place a disproportionate burden on the small and start-up businesses that are likely to derive the most benefit from these proposals. We must make sure that the scheme mechanics are as 'off the shelf' as possible.

It is also worthy of note that in order to improve our labour market still further, the system of Employment Tribunals is in need of reform in that it needs to be made faster and more efficient and many of the presumptions in favour of employees could be more balanced, making it easier for employers to at least resist frivolous claims.

Questions

Where we have not responded to an individual question, it is because we do not have a strong view on the subject explored therein.

Q1. How can the government help businesses get most out of the flexibility offered and the different types of employment status?
Q2. Do businesses feel able to use all three employment statuses? If not, what restricts the use of different statuses?

We believe that as the law currently stands, there is the potential for damaging uncertainty in terms of the employment status of contractors brought in by companies, given that the law offers no certainty on this area and considers each case on its merits.

Without access to advice – which will often prove disproportionately costly to small businesses – it is difficult for small and start-up businesses to have certainty in terms of hiring contract and freelance staff, and this may act as a disincentive for them to take these types of staff on.

Q3. What restrictions, if any, do you think should be attached to the issue of shares or types of shares?

We do not believe that there should be any statutory restrictions attached to the issue of shares, or to the types of shares that can be issued. However, we believe that companies should have the flexibility to impose their own restrictions on any such shares issued.

We believe that this will allow the greatest flexibility to take into account the individual circumstances of the company – for instance, it may be that shares which carry formal voting rights may not be appropriate to issue in the case of a start-up where an individual owner-manager makes the majority of decisions on behalf of the business.

Q4. When an employer buys back forfeit shares, should this be at full market value or some other level (e.g. a fraction of market value) should some other level be allowed in certain circumstances?

We have some concerns that having a statutory requirement to pay a full-market value could lead to situations where an employee-owner who has left the company on bad terms (for instance, in the case of gross misconduct) would nevertheless be entitled to a further reward for their time at the company.

To overcome this issue, we propose that the legislation leave open the potential for the company and employee-owner to, at the time of issue of the shares, draw up a list setting out the circumstances under which it would be permissible for the employer to buy back the shares at a value lower than full-market. Dealing with a long tail of minority shareholders, some of whom may have left the company in acrimonious circumstances is a concern for employers. Therefore reacquiring the shares under these circumstances should be made as straightforward as possible for employers.

There may also be an issue that when employee owners leave – as shareholders they can expect to realise cash value– but ready cash may be relatively difficult to come by given that small businesses tend to have very tight cash flow, and so if the owner/manager is forced to compensate using personal means, they are somewhat disincentivised to utilise the scheme in the first place.

Q5. How should a company go about carrying out a valuation of the shares? What would the administrative and cost impact be for a company if an independent valuation was required?

We would envisage that the company and the employee-owner would together arrive at a mutually agreed valuation of the shares at the time of issue.

Any requirement for an independent valuation would add significant costs to the issue of shares, which in the case of small firms would likely prove disproportionate. This is especially the case where the sums involved could be as low as £2,000 – in these instances, it is likely that the cost of independent external valuation could be higher than the value of shares being issued.

Q6. The Government would welcome views on the level of advice and guidance that individuals and businesses might need to be fully aware of the implications of taking on employee owner status.

Whilst we agree that the employee-owner needs to be fully appraised of the consequences of their taking up employee-owner status, we would envisage this taking the form of a template letter or contract, in the same way that an employee is usually given a contract on starting a term of employment. This would set out in clear fashion the rights which the employee-owner would be giving up. They would then be free to take further legal advice if they so wished. If there was a more onerous requirement, this is likely to add costs which would be borne by the company and which would make the use of the scheme less attractive.

Q7. What impact will allowing individuals limited unfair dismissal protection and equity shares have on employers' appetite for recruiting?
Q8. What benefits do you think introducing the employee owner status in with limited unfair dismissal rights will have for companies?
Q9. Do you think these benefits will be greater for larger, smaller or start-up businesses?
Q10. What impact, if any, do you think the employee owner status will have on employment tribunal claims, e.g. for discrimination?

We believe that the introduction of a new form offering only limited unfair dismissal rights for employees is likely to have an impact in terms of making it more attractive to companies to hire employees – particularly where the company is a start-up or SME and currently is not taking on staff on account of a fear around the repercussions of an unfair dismissal claim, therefore stifling job creation.

However, we would note that as the law currently stands, the unfair dismissal rights that an employee-owner would be giving up would be rights to which they are not currently entitled in the first two years of employment. The potential effects of this are twofold.

Firstly, we have seen the rise of claims in recent years for discrimination amongst those employees who do not have the qualifying two years service to bring an unfair dismissal claim – it is highly likely that this is to circumvent the current rules that do not allow those employees with less than two years service to otherwise claim for unfair dismissal. We have concerns that under the proposed rules, this practice may become widespread amongst employee-owners – with the end result being that employers feel that the benefits of the status are not being realised, and the status is not therefore used. Under the current employment tribunal system, discrimination claims are more complex and costly.

Secondly, given that for the first two years an employee is not able to bring a claim for unfair dismissal, and given that, particularly in the case of start-ups, businesses are concerned about the potential costs of such a claim in the early years particularly, there may be a situation where a business decides that since the proposed scheme offers them no additional protection in the early years of taking on a new employee, they do not find it attractive enough to use.

One partial solution could be to grant eligibility to the shares at commencement of employment, but have these shares start to vest only after a period of two years to correspond with the beginning of the period when normally employees can pursue unfair dismissal proceedings. The shares should come with corresponding tax treatment such as would apply if the shares were offered when the employee joined the company. This would mitigate some risk for employers and make them more likely to adopt the scheme as they are no longer giving away something for nothing in the first two years.

Q11. What impact do you think introducing the employee owner status with no statutory redundancy pay will have for businesses, in particular, smaller businesses and start-up businesses? What negative impacts do you anticipate and how might these be mitigated?

The introduction of the status would be beneficial to small and start-up businesses, as they are at the stage where there is significant uncertainty around the staffing needs of the business.

By having a status where the business would not be liable for statutory redundancy pay, they may feel better able to take on the risk of an employee where the future of that role may be uncertain.

There is a potential negative impact for the employee-owner, particularly in the case where the company becomes insolvent, when as an employee-owner they would not be eligible for redundancy pay. However, the share issue, and the value of that issue, is designed to offset this – the employee-owner effectively takes on a proportion of the risk of the business, but with a commensurate share in any future rewards.

Q12. What impact will this change to maternity notice period have on employers?
Q13. What, in your view, would employers do if employees wish to return early without giving 16 weeks' notice?
Q14. How will these changes impact on a company's payroll provisions?

Q15. What effect will a compulsory 16 weeks' early return notice period have on the length of maternity leave that mothers take or adoption leave that parents take?

Q16. Do you think 4 weeks is the right period? If not, why not? What would be the impact of a shorter or longer period?

We have no particular comments on this aspect of the policy.

Q17. What impact do you think this proposal would have on the ability of employee owners to access support for training?

By awarding equity in the business to employee owners, companies will be better incentivised to offer training opportunities to staff who participate because the likelihood of them making a long-term commitment to the company has increased. The employer owner will benefit from learning new skills and the employer will have a better trained work force committed to the long-term prospects of that company.

Q18. Do you have any comments on the Government's intention not to amend Company Law to implement the employee owner proposal?

We do not have strong views on this.

Q19. The Government welcomes views on particular safeguards that would need to be applied, in order to minimise opportunities for abuse.

We cannot think of any obvious areas for abuse, but would be happy to consider this question again when more detailed tax provisions are available

Q20. The Government welcomes views on whether the existing tax rules which apply to share-for-share exchanges (such as might happen when a company is taken over) and schemes of reconstruction should apply where shares issued in return for taking up the new status are involved

The opportunity for an employee to take up the new status is available (and the decision to take it up is made) on the basis of the company/group's position at that point in time with the incentive for the employee being that the group will grow and the value of their shares will increase. We assume that the Government may be less inclined to allow the capital gains tax exemption to persist in situations where the company/group's position fundamentally changes e.g. as a result of a restructuring or because the company is taken over.

There are of course situations where a restructuring or share for share exchange occurs otherwise than as a result of a fundamental change to the company/group.

For example, a new holding company may be inserted such that the employees acquire equivalent shares in the new holding company in consideration for the acquisition by the new holding company of their existing shares. Similarly, the share capital of the group may be restructured for bona-fide purposes that result in the employee owners holding new shares that are economically equivalent to their previous holdings.
We would therefore envisage that the status does not continue unless it is a 'qualifying exchange' of the sort mentioned in the previous paragraph. In the event that it is not a 'qualifying exchange', we would expect that the capital gains exemption would apply to any gain on the shares up to the date of the share-for-share exchange/reorganisation, but not for any subsequent gain on the replacement securities.

Q21. What impact do you think the proposal will have on labour market flexibility – that is, in relation to hiring and letting people go?

We would anticipate an increase in labour market flexibility as employers become more willing to take people on, just as they may be more willing to let people go in time, if their particular sector faces unexpected challenges.

Q22. Would you be likely to take up the new status? What would the impact of the status be on your business?

n/a

Q23. What are your views on the take-up of this policy by:

a) companies?

b) individuals?

We believe that, subject to the caveats that we have set out above, this could be of potentially large value to small firms who currently experience difficulty in hiring staff, and for whom both the prospect of reducing their risk with regard to unfair dismissal claims and the ability to offer share incentives in the company on a tax-free basis (although currently limited to capital gains tax relief only) could prove beneficial in changing this. As such, we would expect a reasonable take-up of this scheme by start-up companies especially.

In terms of individuals, the rate of take-up will largely depend on the value that they ascribe to their right to claim for unfair dismissal and the extent to which this is met by companies.

It is worth noting in this context that the median award in an unfair dismissal claim is £4,560[1] – therefore there is a question over whether employers would be willing to issue shares far in excess of this amount, which may not meet the expectations of potential employee-owners. We would also stress again the importance of communicating that the scheme is not in any way mandatory.

Q24. What are your views on the equality impact assessment? Are there other equality and wider considerations that need to be considered?

We have no particular comments on this.

[1] Employment Tribunal figures – 12 months to 31 March 2012.